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SUBJECT: Mongolia's Failed Uranium Mining Policy

Ref: 07 UB 238

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11. (SBU) SUMMARY: On February 1, 2010, Canadian uranium exploration company Khan Resources (KR) announced its intent to accept an offer from the Chinese National Nuclear Corporation (CNNC) to buy controlling interest in KR through the purchase of shares. If consummated, CNNC's buyout would give this Chinese state-owned company ownership of Mongolia's two key uranium deposits. This turn of events has caught the government of Mongolia (GOM) flat footed, because the GOM assumed a recently passed 2009 law regarding uranium resources and nuclear power gave it total control over these assets.

However, the law, which was passed in an exceptionally non-transparent fashion, actually weakened GOM control over these assets, leaving Mongolia with few options to balance Chinese state-owned interests. From Post's perspective, this statutory and policy debacle clearly shows the urgent need to continue to push for more transparency and public review of the legislative and regulatory process. END SUMMARY.

A New Nuclear Energy Law Trims Investor Rights

12. (SBU) Passed in early summer 2009 with no public comment or stakeholder review, Mongolia's Nuclear Energy Law severely restricted private development of uranium deposits within Mongolia. In fall 2009, Mongolian People's Revolutionary Party (MPRP) and Democratic Party (DP) Members of Parliament publicly discussed the legislative process applied to the Law before mining industry forum. MP's O. Chuluunbat and E. Bat-Uul explained that a small group of nuclear and national security experts under the direct guidance of then-Prime Minister Bayar controlled the drafting process. These MPs reported, and separate sources confirmed, that Bayar and senior Mongolian political leaders from both parties explicitly instructed their respective MPs to pass the draft quickly with a minimum of debate and review. Senior political leaders argued to Parliament

that national security concerns related to the mining of uranium and nuclear power required immediate passage, and that the MPs needed to trust that Mongolia's national security and nuclear experts effectively crafted a bill that protected national interests. Consequently, within a week of introduction, Parliament passed a bill that most members did not even bother to read. The two MPs opined that they and many others would not have passed the bill if they had scrutinized it more thoroughly, and would not give senior leaders such an easy pass again.

13. (SBU) Four provisions have particularly concerned current rights holders of uranium assets, which include two American-involved firms, Peabody Energy and Dennison Mines:

-- Immediately revokes all current uranium exploration and mining licenses and then requires all holders to register these licenses with the Nuclear Regulatory Agency(NRA), for a fee.

-- Requires investors to accept that the Mongolian state has an absolute right to take -- without compensation -- at least 51 percent of the company that will develop the mine (as opposed to just the deposit) as a condition for being allowed to develop any uranium property.

-- Creates a uranium-specific licensing and regulatory regime independent of the existing regulatory and legal framework for developing mineral and metal resources. Prior to the Uranium Law, exploration licenses gave their respective holders the rights to discover and develop any and all mineral and metal resources discovered within that license area. (This did not include petroleum resources, which are governed separately.) According to GOM officials, this new provision means that the state can issue a distinct license for uranium exploration on a property otherwise

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dedicated to other mineral and metals exploration.

-- Requires firms to obtain GOM approval for sales and purchases of shares in uranium exploration and mining firms on both domestic and foreign exchanges.

Policy Aims Driving Adoption of the Nuclear Law

14. (SBU) Our contacts have been exceptionally frank about what the GOM intended to accomplish with this law. Uranium (and other mineral and hydrocarbon resources for that matter) is first and foremost viewed as a tool to balance Mongolia's political relations among Russia, China, and "third neighbors" (as the GOM puts it) such as the United States. Under this policy, revenues from mining, rule of law, or best practices, are secondary or even tertiary considerations. Mineral assets are not allocated based on what company can best develop the resource for the benefit of shareholders and the Mongolian people; rather, they become part of a strategic calculation. Thus, uranium to Russia, copper to western Rio Tinto, coal to U.S Peabody Energy, and some share of each to China keeps key nations involved in Mongolia without letting one single country dominate, balancing relations while also securing Mongolia's sovereignty. From this perspective, the law's intent is to stop firms from developing and disposing uranium assets in ways that might upset the balance that the GOM seeks to achieve among its first, second and third neighbors.

15. (SBU) The GOM's second goal was to create a value-added nuclear power sector within Mongolia. As explained to emboffs, value-added industrial activities does not mean a well-planned set of developments based on either regional or international market conditions and costs of production; rather, the GOM wants a massive, world-class uranium-processing industrial development that involves the latest in nuclear technology. Because such structures embody the highest hallmarks of development, anything less diminishes Mongolia in the eyes of other states and in the eyes of Mongolians themselves -- or so our sources claim, without providing any proof that the Mongolian public at large shares in this vision.

¶6. (SBU) In the case of uranium, the GOM claims, without much technical proof, that Mongolia holds at least 10 percent of the world's undiscovered uranium. The government argues that so vast a "supply" justifies GOM demands that value-added processing go beyond the "mere" concentration of ore into yellow cake (uranium oxide) as a precondition for access to Mongolia's assumed extensive uranium resources. This value-added vision ranges from advanced nuclear research facilities to nuclear power plants to enrichment facilities -- all costing untold billions of dollars. In this respect, the law would allow the state to strip private firms, such as Canadian exploration junior partner Khan Resources (KR), of their rights because these companies are not committed to such high-end processing; those rights would instead be invested in players from Russia, France, China, or the U.S. that, at least theoretically, are more likely to be in a position to help Mongolia pursue its uranium-based ambitions.

¶7. (SBU) COMMENT: Long-time observers of Mongolia's uranium assets consistently criticize these "value-added" ambitions, arguing that the GOM has never subjected them to any independent analysis. Mongolia claims that it has 10 percent of the world's untapped uranium. However, all experts point to proven reserves that consistently hover around one percent, which might be increased to three percent with more expensive and financially risky exploration, exploration that Western firms are unlikely to do under current law. Privately, most observers dismiss the notion that Mongolia can or should consider power plants and processing facilities anytime soon. Setting aside the fact that Mongolia woefully lacks any capacity,

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the economics of power plants and enrichment facilities are so daunting that even well-endowed uranium states such as Kazakhstan and Australia have declined to establish them. See reftel for current description of Mongolia's uranium resources. END COMMENT)

¶8. (SBU) The GOM has sought to achieve these policy aims by controlling the sale of both exploration and mining licenses and of companies holding Mongolian uranium assets. The law forces companies and other entities to surrender control over both the rights to the deposit and the operational entity that would mine. The GOM has taken this additional step on operational entities to prevent one firm from selling itself to another firm, thus circumventing control over the selling and transfer of licenses themselves. In an effort to limit further the ability to transfer these assets, the law also empowers the GOM to control share sales on any foreign or domestic stock exchange. In fact, as written, the law seems to require any company owning Mongolian uranium assets to seek GOM approval whenever it sells more than seven percent of the shares of any company that a respective firm might hold whether that sale is related to Mongolian uranium assets or not. Just how the GOM would enforce such a provision has yet to be spelled out in the regulations. (NOTE: This latter provision came in response to the Chinese National Nuclear Corporation's (CNNC) purchase of outstanding shares of a Canadian uranium firm in spring 2009, which circumvented existing laws regarding the disposition of exploration and mining licenses. END NOTE.)

Russian Uranium Ambitions in Mongolia

¶9. (SBU) Mongolian policy aims were directly and indirectly influenced by apparent Russian interest in gaining control over key Mongolian uranium resources. Our Mongolian interlocutors candidly described Russian involvement with the law. Most of the Mongolian technical experts advising senior leaders received their nuclear energy training in Russia or were the protgs of Russian trained experts. For this reason, it surprised no one when these advisors and the GOM turned to Russia for support and models for Mongolia's nascent uranium mining and nuclear power sectors. As our contacts related, the Russians were generous: promising support to develop research and training facilities; mining operations; basic processing of ore; and, down the road, nuclear power generation and fuel enrichment. In return for fulfilling Mongolia's isotope dreams, Russia asked Mongolia to expropriate the mining rights from KR and others in eastern Mongolia and vest them in a new state-owned

company jointly owned by Russia and Mongolia, but managed and controlled by Russia. The Russians had hoped to complete this process by August 2009, just in time for President Medvedev to sign a new cooperative agreement with Mongolia during his visit. (NOTE: Russia explored Mongolia's uranium resources from the 1960s through the late 1980s and is well aware that Mongolia's eastern province of Dornod holds the best of Mongolia's limited uranium resources. END NOTE.)

¶10. (SBU) As explained to us, from Russia's perspective, gifting expertise and material upon Mongolia would have the benefit of fencing out western and Chinese interlopers, making the nearby Chinese in particular beholden to Russia for their nuclear supplies. While Mongolia might ordinarily prefer not to have its third neighbors disengage, it might accept their departure if doing so hindered China.

Intended Consequences of a Bad Law:
Western Investment Driven Away

¶11. (SBU) From the perspective of private western firms, the new
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uranium law has been both a disappointment and a disaster. Faced with a blatantly expropriatory law, firms engaged in costly and highly speculative exploration activities saw their share values collapse and investment resources dry up. Consequently, these companies have been forced to sell out to larger firms, mostly state-owned entities from France and China, to recoup a part of their investments. More broadly, Mongolia has taken a hit among international investors, who continue to shy away from investing here because they fear that expropriation in the uranium sector sets a precedent for other sectors.

¶12. (SBU) However, the GOM has expressed no particular concern about these departures and the corresponding damage to its commercial credibility. On the contrary, it rather appears to express satisfaction that uranium assets are slowly but surely being acquired by state-owned or multi-national entities able (if not necessarily willing) to promote value-added processing and seemingly willing to suffer through the indignities of the law. This group includes France's Areva and China's CNNC as well as Peabody Energy from the U.S. Ironically, Russia seems to have become the odd man out.

Russia Rebuffed: An Example of a Hoisted Petard

¶13. (SBU) The negative impact on Russian ambitions in Mongolia's uranium sector has surprised most observers, particularly as it was the Russians who initially seemed to have motivated much of the legislation that was later used to deny them their prize. By all reports, including from some of those who participated in the August 2009 sessions involving senior Russian officials, the Russians pressed for strict terms for their investment. They demanded exclusive control over all entities mining uranium in northeastern Mongolia, not arguing for 50/50 ownership but insisting on 51 percent for Russian and 49 percent for Mongolia. Nuclear power plants and enrichment facilities were off the table. Russia would mine the raw uranium ore, ship it to facilities in the Russian Far East, process it, and pay the Mongolians a royalty and a share of the profits. As for nuclear research and training facilities, that was also off the table, although Mongolians were offered the opportunity to study and train in Russia.

¶14. (SBU) The Mongolians rejected Russia's offer, noting that the new law strictly prohibited Mongolia's entering into such an arrangement. The Mongolians then insisted on the original Russian offer for in-country research, processing, and power facilities, adding that the Russians would have to accept 49 percent and pay for everything. The Mongolian response floored the Russians, who had not anticipated that Mongolia would apply this law to them. Some Western observers thought the Russians might punish the Mongolians

by cutting power or petroleum. However, the Russians apparently took no major or even minor punitive actions. At this point, the Russians have been left with their current holdings in two ongoing uranium exploration projects retained from the socialist era and no obvious, easy entry into other projects.

Unintended Consequence of a Bad Law:
China Trumps Mongolia

¶15. (SBU) While Mongolia was generally satisfied that the new law would constrain Western and Russian ambitions, it apparently did not anticipate China's response. Much of the law was specifically aimed at halting firms from "flipping" Mongolian uranium assets by selling licenses, companies, and shares. For their part, the Chinese appeared to respond by simply ignoring it. In the case of KR, the CNNC decided to acquire KR's shares without consulting the GOM. KR,

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a Canadian company, has the right to sell shares in Canada on the Toronto Exchange or those privately held; CNNC has the right to buy these shares from any exchange or venue where they are legally tendered -- and in these circumstances Mongolian law and policy is irrelevant. At this point, CNNC is well on its way to owning the very uranium holdings that the Russians craved and that the Mongolian government wanted to make the heart of their ambitious nuclear infrastructure.

Comment

¶16. (SBU) So far, the GOM has not yet responded publicly. However, given the long-held GOM concern about its southern neighbor, the GOM is very likely gnashing its teeth, wondering how the Chinese outmaneuvered both the GOM and Russian attempts to gain control over these uranium assets. For their part, the Chinese have been neither subtle nor mysterious; CNNC has acted like any business in terms of seizing an opportunity. Seeing distressed but valuable assets, it made an attractive offer to owners who had for too long suffered nothing but losses at the hands of the GOM. However, unlike a private business, the CNNC, having gotten the uranium rights within its grasp, will fall back on its relationship with the Chinese state, tacitly daring the Mongolians to deny them their rights.

¶17. (SBU) Ironically, all of the GOM's regulatory sleights of hand and statutory stratagems were aimed at keeping uranium assets under Mongolian control. Such aims would certainly have been easier if pliable, privately owned Western firms sensitive to local laws and policy goals were developing the properties. However, it is these firms that have now been driven away. Nor can the Mongolians simply turn to the Russians, who having been rebuffed, may not be eager to save Mongolia from its hasty and poorly conceived policy on terms that Mongolia can easily accept. Inadvertently, the GOM is faced with a situation in which a Chinese state-owned firm holds the high ground on Mongolia's choicest uranium assets. In every respect, GOM policy has failed to achieve what its original sponsors had hoped.

¶18. (SBU) From post's perspective, one of the most encouraging aspects of this statutory and policy debacle is the very public nature of the attacks against both the process of passing this law and its implementation. Normally discreet when discussing disputes and irritations, our sources have been very open about their disdain for this law. Members of Parliament, bureaucrats from the Nuclear Regulatory Agency, Minerals and Energy officials, and the mining industry representatives joined in open debates in print and other fora, analyzing in detail the failings of this law and its negative implications for both Mongolia's national security and its investment climate. Largely reflecting the assessment provided in this cable, the practical effect of this discussion within Mongolia is to clearly underscore the urgent need to continue to push for more transparency and public review of the legislative and regulatory process. Viewed from a more long term perspective, it also underscores the importance of what post, USTR and the GOM have

been undertaking in our mutual effort to negotiate a transparency agreement between the U.S. and Mongolia. END COMMENT.

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